Application Guidance Notes on SLFRS 15 *Revenue from Contracts with Customers: Real Estate Sector*

Background:

SLFRS 15 was adopted in 2015 effective for financial periods beginning on or after 01st January 2018. It recommends a five-step model in the recognition of Revenue as follows:
Step 1 - Identify the contract with the customer
Step 2 - Identify the performance obligations in the contract
Step 3 - Determine the transaction price
Step 4 - Allocate the transaction price to the performance obligations
Step 5 - Recognise revenue when (or as) the entity satisfies a performance obligation

In most instances, the real estate developer (the entity) and the customer enter into a contract for the sale of the real estate unit before the entity constructs it. These are pre-sold on the promise of transferring control at the end of construction.

Prior to SLFRS 15 being effective; generally the real estate companies in the country have recognised the revenue by applying paragraph 22 of LKAS 11 referring the stage of completion method.

The objective of issuing this Application Guidance Notes is to provide additional guidance on the application of SLFRS 15, for the revenue recognition on the real estate contracts.

Analysis:

If one (or more) of the three criteria in paragraph 35 of SLFRS 15 is met, it is considered that the performance obligation is satisfied and revenue can be recognised over time. Further, paragraph 32 of SLFRS 15 states that if an entity does not satisfy a performance obligation over time, it satisfies the performance obligation at a point in time to recognise the revenue.

Paragraph	***Criteria***	***Analysis***
Para 35(a)	The customer simultaneously receives and consumes the benefits provided by the entity's performance as the entity performs.	The entity's performance creates an asset, ie the real estate unit and is **not likely to be consumed immediately**.

Para 35(b)	The entity's performance creates or enhances an asset that the customer controls as the asset is created or enhanced.	***Paragraph 33 of SLFRS 15:*** Control of an asset refers to the ability to direct the use of, and obtain substantially all of the remaining benefits from, the asset. ***IFRIC Agenda 2 analysis (issued in September 2017):*** ▪ Customer is unable to sell the real estate unit itself without holding legal title to it. ▪ Customer has no ability to direct the construction or structural design of the real estate unit as the unit is constructed, nor can it use the part-constructed real estate unit in any other way. ▪ The customer's legal right (together with other customers) to replace the entity, only in the event of the entity's failure to perform as promised, is protective in nature and is not indicative of control. ▪ The customer's exposure to changes in the market value of the real estate unit may indicate that the customer has the ability to obtain substantially all of the remaining benefits from the real estate unit. However, it does not give the customer the ability to direct the use of the unit as it is constructed.
Para 35(c)(i)	The entity's performance does not create an asset with an alternative use to the entity.	***Paragraph 36 of SLFRS 15*:** The asset created does not have an alternative use to an entity, **if the entity is restricted contractually from readily directing the asset for another use** during the creation of that asset or limited practically from readily directing the asset in its completed state for another use. ***Paragraph B6 of SLFRS 15:*** In assessing whether an asset has an alternative use to an entity in accordance with paragraph 36, an entity shall consider the **effects of contractual restrictions and practical limitations on the entity's ability to readily direct that asset for another use**, such as selling it to a different customer. The possibility of the contract with the customer being terminated is not a relevant consideration in assessing whether the entity would be able to readily direct the asset for another use.

Para 35(c)(ii)	The entity has an enforceable right to payment for performance completed to date.	***Paragraph 37 of SLFRS 15:*** To have an enforceable right to payment; at all times throughout the duration of the contract, the **entity must be entitled to an amount that at least compensates the entity for performance completed to date; if the contract is terminated by the customer** for reasons other than the entity's failure to perform as promised. In assessing whether it has an enforceable right to payment, an entity considers the **contractual terms** as well as any **legislation** or **legal precedent** that could supplement or override those contractual terms. ***Para B11 of SLFRS 15:*** **If a customer acts to terminate a contract without having the right to terminate the contract at that time** (including when a customer fails to perform its obligations as promised), the contract (or other laws) **might entitle the entity to continue to transfer to the customer the goods or services promised in the contract and require the customer to pay the consideration promised in exchange for those goods or services**. Then, **an entity has a right to payment for performance completed to date because the entity has a right to continue to perform its obligations in accordance with the contract** and **to require the customer to perform its obligations** (which include paying the promised consideration). Further, an entity also needs to consider whether the right to payment for performance completed to date is enforceable. ***Paragraph B12 of SLFRS 15:*** In assessing the existence and enforceability of a right to payment for performance completed to date, an entity shall consider the contractual terms as well as any **legislation or legal precedent** that could supplement or override those **contractual terms**. This would include an assessment of whether: (a) **legislation, administrative practice or legal precedent confers upon the entity a right to**

		payment for performance to date even though that right is not specified in the contract with the customer; (b) **relevant legal precedent** indicates that similar rights to payment for performance completed to date in similar contracts have no binding legal effect; or (c) **an entity's customary business practices** of choosing not to enforce a right to payment has resulted in the right being rendered unenforceable in that legal environment. However, notwithstanding that an entity may choose to waive its right to payment in similar contracts, an entity would continue to have a right to payment to date if, in the contract with the customer, its right to payment for performance to date remains enforceable.

Paragraph 45 of SLFRS 15:
In some circumstances (for example, in the early stages of a contract), an entity may not be able to reasonably measure the outcome of a performance obligation, but the entity expects to recover the costs incurred in satisfying the performance obligation. In those circumstances, the entity shall recognise revenue only to the extent of the costs incurred until such time that it can reasonably measure the outcome of the performance obligation.

Recommendation:

Management has to exercise the judgement in **evaluating whether <u>one of the criteria in the paragraph 35</u> of SLFRS 15 is met,** in order to consider that the performance obligation is satisfied and **revenue can be recognised over time** and otherwise it satisfies the performance obligation at a point in time to recognise the revenue.

Paragraph	***Criteria***	***Recommendation***
Para 35(a)	The customer simultaneously receives and consumes the benefits provided by the entity's performance as the entity performs.	Since, the entity's performance creates an asset, (ie the real estate unit) and that is **not likely to be consumed immediately; this criteria may not be met**.

Para 35(b)	The entity's performance creates or enhances an asset that the customer controls as the asset is created or enhanced.	The customer does not have the ability to direct the use of the real estate unit as it is being constructed, unless it is permitted under the agreement and thus the **customer is highly unlikely control the part-constructed unit**.
Para 35(c)(i)	The entity's performance does not create an asset with an alternative use to the entity	As the contractual restriction on the entity's ability to direct the promised residential property for another use is substantive, the promised residential property **does not have an alternative use to the entity.**
Para 35(c)(ii)	The entity has an enforceable right to payment for performance completed to date	In assessing the existence and enforceability of a right to payment for performance completed to date, an entity shall consider the contractual terms as well as any legislation or legal precedent that could supplement or override those contractual terms. In the absence of **no legislations or legal precedents**, in determining whether the entity has an enforceable right to payment for performance completed to date; **contractual terms** (eg: specific performance clause) that allows enforceability **will have to be considered in making the judgement of the management in revenue recognition**.

Further, in circumstances where an entity is not be able to reasonably measure the outcome of a performance obligation, but expects to recover the costs incurred in satisfying the performance obligation; it shall recognise revenue only to the extent of the costs incurred until such time that it can reasonably measure the outcome of the performance obligation.